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March 12, 1993

Donna R. Searcy, Secretary
Federal Communications Commission
Washington, D.C. 20554

In re: MM Docket No. 92-266
<u>Ex</u> <u>parte</u> filing

Dear Ms. Searcy:

Please associate the enclosed materials with the public docket in the above-referenced proceeding.

Should there be any questions regarding this matter, please contact the undersigned.

Very truly yours,

Arthur H. Harding

Arthur H. Harding
Counsel for Falcon Cable TV

AHH/sbc/5199
Enclosure

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MAR 1 2 1993

MARGINAL CASH FLOW TEST AS
A RATE ANALYSIS MECHANISM
SHORT OF COST OF SERVICE REGULATION

The Commission recognizes that in processing "bad actor" complaints alleging that "cable programming service" rates are unreasonable, after applying whatever tests and standards as may be established by the Commission, some cable operators will be unable to demonstrate that such rates are not unreasonable. In such circumstances, the Commission may be faced with a full-blown cost of service showing as the cable operator's "last resort." While the statutory factors in Sec. 623(c)(2) clearly mandate that the cost of service showing alternative must be made available to operators seeking to avoid rollbacks of cable programming service rates alleged to be unreasonable,[1] the Notice also recognizes serious drawbacks to such an approach,[2] particularly if this is the only available methodology for the Commission, and especially during the initial 180-day window pursuant to Sec. 623(c)(3) of the Act.

Falcon Cable TV ("Falcon") proposes a streamlined mechanism which could be employed by cable systems as a procedural alternative to otherwise making a cost of service showing. It is not meant to preclude any other showings or defenses which the Commission may adopt. Falcon's "marginal cash flow" test relies on readily obtainable financial information which can be derived without resort to complex cost-based accounting or a uniform system of accounts and offers a useful mechanism to guard against truly unreasonable rates without impeding the ability of the cable industry to continue to improve its facilities and programming offerings.

As explained in detail below, the "marginal cash flow" test would provide an alternative to a cost of service hearing whereby a cable operator could demonstrate that a challenged cable programming service rate[3] is not unreasonable so long as the ratio of operating cash flow generated by the system from all cable services to the sum of debt service plus capital expenditures does not exceed 1.20:1.

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[3]One of the principal advantages of the "marginal cash flow" test proposed by Falcon is that it <u>does</u> <u>not</u> require complicated allocations of revenues or capital expenditures. Such an approach lends itself perfectly to the "rates as a whole"

Procedurally, the "marginal cash flow" test would work as follows. Where a cable operator has failed to satisfy any of the criteria established by the Commission for determining whether a challenged cable programming service rate is unreasonable, and thus is faced with a cost of service hearing as the final alternative to a rate rollback, the cable operator would then be allowed to provide the financial data specified by the Commission to allow the marginal cash flow analysis to be undertaken. If the Commission determines that the data documents a ratio of operating cash flow to debt service plus capital expenditures of 1.20:1 or less, the complaint would be dismissed. This is analogous to a summary judgment procedure which would obviate the need for a cost of service hearing. If the marginal cash flow test is not satisfied, the cable operator could always go forward with a full-blown cost of service proceeding before the Commission or pursue any other available options, such as a rate reduction or prospective credit.

The application of the marginal cash flow test proposed by Falcon is simple, straightforward and readily verifiable. First, system revenues from cable television operations would be calculated.[4] This is a figure which is maintained by all cable operators and is the base for revenues subject to the franchise

[4]For rate challenges during the initial 180-day window, total revenues derived from cable television operations by the affected system during the most-recently completed fiscal year would be reported. For future rate challenges, historical annual revenues could also be utilized, possibly adjusted by the anticipated revenues to be derived from the rate increase being challenged.

fee limit codified in Sec. 622 of the 1984 Cable Act. For example, the revenue figure would include, but not be limited to, revenues derived from recurring cable service fees, second sets, installations, remote controls and other cable equipment, and advertising. Operating expenses[5] are then deducted from revenue to yield operating cash flow. Operating cash flow is then divided by the sum of debt service (principal and interest payments)[6] and a pro rata allowance for system-related capital expenditures incurred over a five-year period. So long as the ratio of operating cash flow to the sum of debt service and capital expenditures[7] is 1.20:1 or less, the system would be able to successfully defend a complaint as to unreasonable rates.

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[5]For the purposes of ease of verification, the calculation would be based on actual operating expenses incurred during the

The pro rata allowance for capital expenditures requires further explanation. First of all, it is beyond dispute that any regulatory scheme which deprived cable operators of sufficient revenues to reinvest in capital improvements would contravene one of the five fundamental policy goals of Congress in adopting the 1992 Cable Act, to "ensure that cable operators continue to expand, where economically justified, their capacity and the programs offered over their cable systems."[8] However, capital expenditures related to a particular system may vary widely from year to year. In the event of a major system rebuild, for example, an unusually large amount of capital might be invested in a particular year. If this entire amount were included in the calculation for the current year, a cable operator might be able to justify a sharp increase in rates. To ameliorate this effect, it is proposed that the "capital expenditure" figure be calculated by including 20% of actual system-related capital expenditures for the previous four years[9] and 20% of budgeted capital expenditures for the current year. If for some reason the budgeted capital expenditures for the current year are not fully spent, the pro rata allowance for that year can be adjusted appropriately in the next four years going forward.

Attached as Exhibit A is an example demonstrating how the

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[8]1992 Cable Act, Sec. 2(b)(3).

[9]Historical capital expenditures can be verified through a CPA confirmation letter, as explained <u>infra</u>. In cases where historical data is not available, good faith estimates may be required based on extrapolation of available data.

marginal cash flow computations would be performed. To the extent any of these figures are challenged, the cable operator would be required to submit a statement to the FCC from an outside certified public accounting firm verifying that the amounts have been calculated in accordance with generally accepted accounting principles and that the allocations (e.g., of joint and common expenses) are reasonable. Attached as Exhibit B is a representative form of outside accountant's letter which cable operators should be in a position to provide.

The foregoing approach is consistent with numerous statutory goals expressed by Congress in the 1992 Cable Act and by the Commission in its Notice. First, it would provide a fair and expeditious procedure which is substantially less burdensome than a cost of service hearing, consistent with the goals of Sections 623(c)(1)(B) and (b)(2)(A) of the Act. It would not require the development of a complex and burdensome "cost allocation manual," which a cost of service approach would require and which the Act's legislative history expressly disavows.[10] The "marginal cash flow" test in one simple calculation takes into account the numerous expense and revenue items which the Commission would be required to consider by Sec. 623(c)(2)(D)-(F) of the Act in a

[10]House Report at 83.

cost of service hearing.[11] Finally, the proposed test would provide a streamlined "last step" short of a cost of service hearing, establishing a reasonable balance between the goals of insuring that overall cable rates are not unreasonable while at the same time allowing efficient cable operators to attract capital and make investments in improved facilities and innovative programming options.

There are certain safeguards which might be added to the Falcon proposal in order to more fully effectuate Congressional intent. First of all, the Commission certainly does not wish to create a situation which authorizes continual rate increases for the purpose of servicing an excessive debt load. Nor does the Commission desire to create a "safe harbor" to protect those operators which overextended themselves with debt in order to finance acquisitions. Thus, debt service on debt which exceeds six and one half times operating cash flow would be excluded from to insure that it continues to reflect the realities faced in the cable lending market.

Similarly, the Commission does not wish to allow cable subscription revenues to subsidize debt incurred for non-cable purposes.[12] Accordingly, as to any borrowings incurred after the effective date of these rules, debt service would be allowed to be taken into account for purposes of this test only in proportion to the amount of such borrowings which have actually been reinvested in operations or capital improvements relating to the specific system at issue. However, debt service for borrowings incurred prior to the effective date of these rules television industry be simply ignored. Rather than embark on such a treacherous course, we believe that the problem of "excessive" preexisting debt can be addressed by prohibiting debt service on debt in excess of 6.5 times operating cash flow from being taken into account in the marginal cash flow test, as cash flow, i.e., revenues will exceed operating expenses. However, a bank is unwilling to lend money even to a system with positive cash flow unless there is a sufficient "margin" of "free" cash flow in order to make principal and interest payments owed on the loan and to fund necessary capital expenditures. Thus, lenders to the cable television industry typically include, in addition to other financial covenants designed to insure repayment of loans within an 8 to 9 year time period, a covenant requiring that the ratio of operating cash flow to allowable fixed charges (as defined above) be maintained at an average level of at least 1.20:1 to insure that the operator will have sufficient revenue to pay operating expenses, service debt, and comply with capital expenditure requirements.

Indeed, loan agreements commonly in place in the cable industry today often provide that, if a cable operator fails to satisfy a 1.20:1 marginal cash flow ratio or other similar covenants, the borrower is deemed to be in default. While the bank would typically be entitled to commence foreclosure proceedings in the event of a default, such draconian measures previously have been rarely instituted in practice. Rather, based on historical experiences, at a very minimum the bank would typically demand a restructuring fee, a higher interest rate (since the loan has been shown to be more risky), and in all likelihood will place tight controls on the freedom of the operator to make capital expenditures. Thus, if the Commission fails to allow cable operators to maintain a reasonable cash flow margin, the result is likely to be even <u>greater</u> amounts of cable revenues diverted away from system improvements or programming innovations to satisfy these higher interest rates, and to limit the ability of cable operators to make planned capital expenditures. The foregoing results would clearly disserve the public interest and could not have been intended by Congress. The marginal cash flow test provides a "fail safe" mechanism which allows the Commission, the cable operator and the complainant to avoid becoming embroiled in potentially protracted cost of service hearings, while simultaneously guarding against truly unreasonable rates without imposing such anti-consumer side effects as described above.

In addition, it must be recognized that cable television is an extremely capital intensive industry. Constant capital expenditures are necessary just to keep pace with the staggering onslaught of technical improvements and programming and service innovations. Thus, a sufficient cash flow surplus must be available for capital expenditures, or the ability of the cable industry to respond to technological advances will be handcuffed. Indeed, capital expenditures are often imposed by franchising authorities in the form of contractual obligations incorporated into the franchise. The new FCC technical standards and ongoing CLI compliance responsibilities require the ability to continually invest capital back into cable systems. Similarly, the 1992 Cable Act itself is certain to impose numerous additional financial burdens on cable operators. Although the ultimate extent of such costs is as yet undetermined, a few obvious examples include retransmission consent, anti buy-through, customer service standards and consumer equipment compatibility requirements. The marginal cash flow test provides the cable operator with the flexibility to borrow the funds which may be necessary to respond to such future financial demands, while at the same time promoting reasonable levels of leverage and guarding against excessive profit.

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EXHIBIT A

EXAMPLE OF MARGINAL CASH FLOW COMPUTATION
($IN 000'S)

	Example A	Example B	Example C
I. CALCULATE OPERATING CASH FLOW			
Revenues	$ 5,661	$ 3,056	$12,875
Minus: Operating Expenses	2,580	1,323	5,839

DEFINITIONS

Revenues: All revenues derived by the system from cable television operations during the most recently completed fiscal year. For example, revenues would include, but would not be limited to, revenues derived from recurring cable service fees, second sets, installations, remote controls, cable equipment rentals, and advertising. This gross revenue figure should be readily ascertainable. In many cases, this is the base figure reported to franchising authorities for the purpose of calculating franchise fees.

Operating Expenses: Expenses incurred by the system during the 12-month period described above. Taxes and other cash expenses would be included. Partnerships, which do not themselves pay income taxes, would be allowed to factor the pro forma effect for taxes into the expense calculation so as not to unfairly discriminate against partnerships versus corporations. Interest and non-cash expenses including, but not limited to, depreciation and amortization, would not be included. Extraordinary gains or losses also would not be included. A reasonable allocation of overhead (joint and common expenses) would be allowed. An allocation based on percentage of total subscribers would be presumed reasonable.

Debt Service: Projected debt service can be determined for the current fiscal year based on existing debt level and interest rates. This information should be readily available from a loan amortization schedule. Again, the cable operator would be directed to make a reasonable allocation of debt service expenses among groups of systems covered by a given loan or debt instrument.

Capital Expenditures: This amount is calculated by including 20% of actual system-related capital expenditures for the previous four years and 20% of budgeted capital expenditures for the current year. Historical capital expenditures can be verified through a CPA confirmation letter. In cases where historical data for all four years is not available, good faith estimates may be required based on extrapolation of available data. If for some reason budgeted capital expenditures for the current year are not fully spent, the pro rata allowance for that year can be adjusted appropriately in the next four years going forward.

<u>EXHIBIT B</u>

**Sample Auditor Letter To
Verify Figures Used For
Marginal Cash Flow Computations**

BDO SEIDMAN

1900 Avenue of the Stars, 11th Floor
Los Angeles, California 90067
Telephone: (310) 557-0300
Telecopier: (310) 557-1777

Accountants and Consultants

March 5, 1993

Mr. Michael K. Menerey
Falcon Cable TV
10900 Wilshire Boulevard
Los Angeles, CA 90024

Dear Mr. Menerey:

You requested that we review the accounting and auditing literature to determine the extent of comfort that BDO Seidman can render in connection with issuing a report on schedule of marginal cash flow computation. I understand that Falcon is proposing that the marginal cash flow computation be defined and included in the regulations, which are soon to be issued by the Federal Communications Commission ("FCC") in response to the 1992 Cable Act.

Statement on Auditing Standards No. 62 "Special Reports" prescribes the form and content of auditors' reports issued in connection with "compliance with aspects of contractual agreements or regulatory requirements related to audited financial statements".

Attached to this letter is the type of report which could be rendered in connection with the computation of marginal cash flow (as defined) for submission to the FCC to comply with the FCC's regulations.

If you have any questions or comments, please contact me.

Sincerely,

Martin Paravato

Martin G. Paravato,
Partner

/bsl

Enclosures

BDO SEIDMAN

1900 Avenue of the Stars, 11th Floor
Los Angeles, California 90067
Telephone: (310) 557-0300
Telecopier: (310) 557-1777

Accountants and Consultants

INDEPENDENT AUDITORS' REPORT
ON
SCHEDULE OF MARGINAL CASH FLOW

Falcon Cable TV
Los Angeles, California

We have audited the accompanying schedules of marginal cash flow (as defined in the regulations issued by the FCC in connection with the 1992 Cable Act) of Falcon Cable (name of system) for the year ended December 31, 1993. The schedule is the responsibility of the Company's management. Our responsibility is to express an opinion on these schedules based on our audit.

We conducted our audit in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedules of marginal cash flow is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule of marginal cash flow. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall schedule presentation. We believe that our audit provide a reasonable basis for our opinion.

EXHIBIT C

Letters From Lenders And Investment Banks

BANK OF BOSTON

March 5, 1993

Mr. Michael K. Menerey
Chief Financial Officer
Falcon Cable TV
474 S. Raymond Ave. Suite 200
Pasadena, CA 91105

Dear Mike:

You have requested a response from the bank regarding generally accepted lending parameters for our cable television debt portfolio, specifically with regard to the total debt to cash flow ratio and fixed charge coverage ratio. As you know, Bank of Boston is a leader in cable television finance with $1.2 billion in commitments to the industry, placing us as a top-6 lender to cable television today. Our cable portfolio is comprised of 41 credit facilities to individual cable operators spread across the United States.

We understand that you have proposed to the FCC an alternative of evaluating cable service rates that incorporates certain traditional credit ratios, namely total debt to cash flow and a fixed charge coverage test. We also understand that your proposal is intended to provide the FCC with a simple, expeditious mechanism for evaluating complaints lodged against cable operators whose rates might fall outside the FCC's benchmarks.

It is important to us that the industry continue to have access to the capital markets and that their existing and future free cash flow be sufficient to cover, with a reasonable cushion, debt service and capital expenditure requirements. The credit standards in this regard are more conservative today than the standards banks applied just a few years ago. Today, the bank market would typically demand maximum total debt to operating cash flow no greater than 6.5x. Bondholders and other institutional lenders will tolerate somewhat higher debt to cash flow ratios than the bank market. Fixed charge coverage is defined as Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), less cash taxes, divided by the sum of interest, mandatory principal payments on total debt and capital expenditures. The bank market today needs to see fixed charge coverage averaging 125% or greater over the first five years of a bank financing.

Please let me know if there is anything else I can provide.

Sincerely,

James C. Lewis

James C. Lewis
Division Executive
Media & Communications

NationsBank
P. O. Box 831000
Dallas, TX 75283-1000
Tel 214 508-6262

NationsBank

March 5, 1993

Mr. Michael K. Menerey
Chief Financial Officer
Falcon Cable TV
474 S. Raymond Ave., Suite 200
Pasadena, CA 91105

Dear Mike:

You have requested a response from the bank regarding generally accepted lending parameters for our cable television debt portfolio, specifically with regard to the total debt to cash flow ratio and fixed charge coverage ratio. As you know, NationsBank is a leader in cable television finance with approximately $1.6 billion in commitments to the industry, placing us as the #1 domestic and #3 worldwide lender to cable television today. Our cable portfolio is comprised of 58 credit facilities to individual cable operators spread across the United States.

We understand that you have proposed to the FCC an alternative of evaluating cable service rates that incorporates certain traditional credit ratios, namely total debt to cash flow and a fixed charge coverage test. We also understand that your proposal is intended to provide the FCC with a simple, expeditious mechanism for evaluating complaints lodged against cable operators whose rates might fall outside the FCC's benchmarks.

It is important to us that the industry continue to have access to the capital markets and that their existing and future free cash flow be sufficient to cover, with a reasonable cushion, debt service and capital expenditure requirements. The credit standards in this regard are more conservative today than the standards banks applied just a few years ago. Today, the bank market would typically demand maximum total debt to operating cash flow no greater than 6.5x. Bondholders and other institutional lenders will tolerate somewhat higher debt to cash flow ratios than the bank market. Fixed charge coverage is defined as Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), less cash taxes, divided by the sum of interest, mandatory principal payments on total debt and capital expenditures. In general, the bank market today needs to see fixed charge coverage averaging 125% or greater over the first five years of a bank financing.

Please let me know if there is anything else I can provide.

Sincerely,

Douglas S. Stuart
Vice President
(214) 508-0922

g:\ww\tv\d8s\falcon.ltr

FIRST CHICAGO
The First National Bank of Chicago

Western Communications Division
One First National Plaza
Mail Suite 0083
Chicago, Illinois 60670 - 0083
Telephone: (312) 732 - 3719
FAX: (312) 732 -7727

March 8, 1993

Stephen Martin
Vice President / Division Head

Mr. Michael K. Menerey
Chief Financial Officer
Falcon Cable TV
474 S. Raymond Avenue
Suite 100
Pasadena, California 91105

Dear Mike:

You have requested a response from First Chicago regarding our cable television lending parameters, specifically with regard to the total debt to cash flow ratio and fixed charge coverage ratio. As you know, The First National Bank of Chicago has been a leader in cable television finance for over 20 years, with more than $1 billion in commitments to the industry, placing us as one of the top lenders to cable television today. Our cable portfolio is comprised of more than 80 individual credit facilities to cable operators spread across the United States.

We understand that you have proposed to the FCC an alternative of evaluating cable service rates that incorporates certain traditional credit ratios, specifically total debt to cash flow and a fixed charge coverage test. We also understand that your proposal is intended to provide the FCC with a simple, expeditious mechanism for evaluating complaints lodged against cable operators whose rates might fall outside the FCC's benchmarks.

It is important to us that the industry continue to have access to the capital markets and that their existing and future operating cash flow be sufficient to cover, with a reasonable cushion, taxes, debt service and capital expenditure requirements. The credit standards in this regard are more conservative today than the standards banks applied just a few years ago. Today, the bank market would typically allow, for new deals, maximum total debt to operating cash flow of no greater than 6.5x. It is our experience that bondholders and other institutional lenders will tolerate somewhat higher debt to cash flow ratios than the bank market. Because of this and the fact that the bank standard of 6.5x is tighter than just a few years ago, many existing cable TV companies have, today, total debt to operating cash flow ratios which exceed 6.5 times. This is an important fact to realize when viewing the appropriate level of debt for determining the interest component in a fixed charge test. Fixed charge coverage is defined as Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), less cash taxes, divided by the sum of interest, mandatory principal payments on total debt and capital expenditures. The bank market today generally expects fixed charge coverage to average 125% or greater over the first five years of a bank financing.

Please let me know if there is anything else I can provide.

Sincerely,

SM:bhp

THE BANK OF NEW YORK
NEW YORK'S FIRST BANK - FOUNDED 1784 BY ALEXANDER HAMILTON

ONE WALL STREET, NEW YORK, N.Y. 10286

March 8, 1993

Mr. Michael K. Menerey
Chief Financial Officer
Falcon Cable TV
474 S. Raymond Avenue, Suite 200
Pasadena, CA 91105

Dear Mike:

You have requested a response from the bank regarding generally accepted lending parameters for our cable television debt portfolio. As you know, The Bank of New York is a leader in cable television finance with $1,350MM in commitments to the industry, placing us as one of the top three lenders to cable television today. Our cable portfolio is comprised of 42 credit facilities to individual cable operators spread across the United States.

We understand that you have proposed to the FCC an alternative of evaluating cable service rates that incorporates certain traditional credit ratios. We also understand that your proposal is intended to provide the FCC with a simple, expeditious mechanism for evaluating complaints lodged against cable operators whose rates might fall outside the FCC's benchmarks.

It is important to us that the industry continue to have access to the capital markets and that their existing and future free cash flow be sufficient to cover, with a reasonable cushion, debt service and capital expenditure requirements. The credit standards in this regard are more conservative today then the standards bank applied just a few years ago. Today, the bank market would typically demand maximum total debt to operating cash flow no greater than 6.5x. Bondholders and other institutional lenders will tolerate somewhat higher debt to cash flow ratios than the bank market. Fixed charge coverage is defined as Earnings Before Interest, Taxes, Depreciation and Amortization ("EBITDA"), less cash taxes, divided by the sum of interest, mandatory principal payments on total debt and capital expenditures. The bank market today needs to see adequate fixed charge over the life of a financing.

Please let me know if there is anything else I can provide.

Sincerely,

Brendan T. Nedzi
Vice President

BankCal

THE BANK OF CALIFORNIA

VIA FEDERAL EXPRESS

March 8, 1993

Mr. Michael K. Menerey
Chief Financial Officer
Falcon Cable TV
474 S. Raymond Ave., Suite 200
Pasadena, CA 91105

Dear Mike:

You have requested a response from the bank regarding general lending parameters for our cable TV portfolio, specifically with regard to the Total Debt to Cash Flow ratio and the Fixed Charge Coverage ratio. As you know, The Bank of California, N.A. is a leader in cable TV finance with $430 million in commitments to the industry, placing us among the top 30 lenders to the industry. Our cable TV portfolio is comprised of 30 credit facilities to individual cable TV operators spread across the United States.

We understand that you have proposed to the FCC an alternative of evaluating cable TV service rates that incorporates certain